



Suncoast Equity Management, Inc.

July 1, 2011

Dear Client:

The equity market maintained the gains achieved in the first quarter. News reports about recent sluggish growth in the U.S. economy, the malaise of uncertainty coming from our legislators and worries about Greece's debt held back the market in the second quarter. Valuations for equities look attractive compared to fixed investments. Furthermore, our companies continue to show rising profits and intrinsic value growth.

Portfolio Update

In a global economy, certain brands transcend cultures. Brands like **Apple** (AAPL), **Nike** (NKE), **Pepsi** (PEP) and **Visa** (V) work everywhere. What sets such companies apart is their overwhelming brand power in large markets such as China and India. AAPL and NKE are great examples of brand power that require no explanation. In fact, in its recent earning report, future orders for NKE products surged 24% in China and 25% in other emerging markets. Other products aren't so fortunate. Consider **Boeing** (BA), a brand name and a virtual duopoly with Airbus. However, no one in the U.S. or overseas boards a commercial carrier such as Southwest or Singapore Air and says I only want to fly on a Boeing aircraft. Likewise, growth overseas for Boeing can be tough if a country such as China decides it is in its vital interest to create its own airplane manufacturing industry. While BA is a solid company, sneakers and iPads are not a vital interest to other countries but very profitable to us as long-term investors. These subtle distinctions are what make for more successful long-term investments.

As you know, we are attracted to companies that possess wide moats, or businesses that sport sustainable competitive advantages. Companies with strong moats usually earn excess economic profits. **Pepsi's** steady and highly profitable business takes advantage of its scale. While the company has reached a plateau in the U.S. soda business, it accounts for about 40% of the global market in salty snacks and is nearly ten times larger than the next closest competitor. Its practice of distributing directly to stores, unlike competitors who deliver to central warehouses, gives PEP a cost advantage and an ability to react quickly to consumer preferences to win their business and market share.

Over time a moat that a company possesses can get stronger or weaker. We are constantly looking for clues in this regard. For example, during the quarter, **Visa** got unrecognized affirmation of its competitive strength when the biggest U.S. wireless carriers (AT&T and Verizon) announced they were scaling back a joint venture to create a new mobile payments system. They discovered that setting up a separate network would have been too difficult and time consuming. So instead, they plan to include V and MasterCard in the effort. V is one of the best firms to continue benefitting from the growth in the paper-free payment needs of its customers. The Nilson report projects that paper-free will reach 64% of total payments by 2013, and that card transactions will expand to 50% from the current mid 40% level. V and MasterCard did experience a recent setback from the continued progress of the Durbin regulations; but it was not as onerous as first expected and we believe both businesses will continue to grow and reward us as part-owners of the business.

A new addition to our portfolio is **Franklin Resources** (BEN). BEN is an investment services company with a focus on the management and distribution of hundreds of mutual funds. The company is a very profitable and well run business with nearly \$700 billion in assets under management with close to a third of its clients residing outside the U.S. Its products carry very strong brand names including Franklin, Templeton, Mutual Series, Bissett, Darby Overseas and Fiduciary Trust. Over the years BEN has built significant scale and geographic reach to its operations and distribution channels that we believe make it one of the best-positioned in its industry.

Some of our investments in technology companies are being valued like dinosaurs. It seems unprecedented to us to have **Apple**, **Google** and **Microsoft** selling at current valuations. These three companies along with our other holdings including **Accenture** and **Checkpoint**, provide products and services that drive productivity advances and communications, benefit from large markets overseas and are at the early stages of cloud computing. Not much has to go right for a few of these companies to enjoy significant appreciation.

Worry Under the Microscope

Towards the end of the quarter, public frustrations with our government's ability to develop a sound budget and long-term plan to reduce our debt reached new highs. With the nation's debt at 60%+ of GDP and rising, up from 30% less than five years ago, the markets would gain confidence if our lawmakers could see their way to spending cuts at a rate of \$5 for every \$1 in tax hikes. Michael Boskin, a Stanford University professor, called for this proven program of the past to successfully reduce our deficit today and going forward. Also, we need to let economic growth increase tax revenues not tax rate increases. A program to make the U.S. more competitive by lowering and simplifying our corporate tax rate would be a step in the right direction. We also need to lower the tax on repatriation of cash. Companies are flush with cash but much of it sits overseas. Lowering these tax rates will make us more competitive and broaden the tax base.

Second quarter employment and manufacturing reports did not inspire confidence in the economy. However, the data points remain positive and one overlooked point could be that the sluggishness is temporary. As each day passes we see fewer updates on Japan. The world has almost forgotten that supply-chain problems hit many industries in the second quarter, especially the auto and technology sector. Production should be back on track in the third quarter or so. But for the year we will likely see GDP growth in the neighborhood of 2.5% - 3% instead of the original consensus of 3%-4%.

As investors, we should remember the difference between the U.S. economy and the U.S. stock market. In the past, these two were closely tied. If the economy fell the stock market did as well, because much of the business was done on our soil. Today more than 40% of the revenues of U.S. listed companies come from overseas. Some recent predictions highlight that over the next five years 70% of the incremental earnings growth will come from outside the U.S. Consequently the direction of the U.S. stock market may be more favorable than the U.S. economy. Our products and services are in global demand because the U.S. remains the innovative and entrepreneurial leader with the most creative businesses and best universities.

Equities Best House in the Neighborhood - Comparative Yields and Inflation

This may sound like a broken record, but if the information is indeed worth repeating then c'est la vie. Equities are attractive and bonds purchased today can be hazardous to your pocketbook. This conclusion is drawn from the relative value of stocks versus bonds and the current onset of inflation. Below is a list of yields:

| <u>Yields</u> | <u>US Treasury Bonds</u> | <u>Municipal Bonds (AAA)</u> | <u>Corporate (AAA)</u> |
|---------------|--------------------------|------------------------------|------------------------|
| 2 Year | 0.5% | 0.6% | 1.1% |
| 5 Year | 1.8% | 1.4% | 1.9% |
| 10 Year | 3.2% | 2.9% | 3.3% |
| 20 Year | 4.1% | 4.2% | 4.9% |

Source: Yahoo Finance and Charles Schwab & Co.

The rates in the above tables are close to if not hovering around historical lows for bonds and top out at 4.9% for 20 year securities. Comparatively, the S&P and SEM's yield (or earnings yield, which is the inverse of the price to earnings ratio) is in excess of 7%. Over the life of the bonds above, the coupon (earnings) is fixed. For equities the coupon, while it is subject to the ebb and flow of the economy, *generally grows over time*, especially if your focus is the long-term ownership of high-quality businesses. You might have noticed that the above table does not adjust for the tax effective yields for municipal bonds. Making this adjustment, municipal bonds offer competitive returns. Investors still have a fixed coupon, however, and have to go out 20 years to earn yields as attractive as equities.

The Achilles heel to bonds (and cash) is inflation. Although we have seen commodity prices ease recently, providing some near term relief at the grocery store and the gas pump, global demand growth is leading to higher costs, prices and inflation. But rising commodity prices are not the only pressure points that lead to inflation or rising rates. Higher wages in emerging nations are a root cause, as well. For more than a decade, low wage workers in China and other developing economies produced cheap goods that U.S. consumers feasted on. Now citizens of these countries want to enjoy the same products they have been shipping to the U.S. and are demanding higher salaries to afford it. Fiscal irresponsibility in "mature" (an oxymoron for sure) nations can also lead to inflation. High debt levels instigate "leaders" to print money in one form or another and erode the value of their respective currencies. Importantly, if rates rise with inflation then bond

investors can face steep losses of capital if they need to sell their bonds before maturity. Conversely, if investors hold onto their bonds they struggle to keep pace month after month with low fixed income rates against rising living expenses. Inflation is the enemy of the bond investor and combined with low absolute returns, fixed income securities is a category that is significantly less attractive than common stocks with steadily rising profits. Each market, with the exception of the Treasury market since it is so efficient, can provide select opportunities. But generally speaking, equities are clearly the best house in the neighborhood.

Conclusion

We expect a general rise in worldwide economic activity, in spite of the recent pause in the U.S. recovery and additional structural issues in the U.S. We believe the current environment greatly favors a portfolio of high quality businesses with steadily rising earnings, especially versus most fixed income investments. On our journey to preserving your capital and making it grow, we have confidence that our investment strategy is working. We believe it will produce, as it has so far, good long-term results while taking less risk than most. We welcome your call at any time and continued thanks for your support.

Sincerely,

Donald R. Jowdy
President

Suncoast Equity Management, Inc.

Performance results versus the Standard & Poor's 500 Index

| <u>Time Period</u> | <u>SEM % Return*</u> | <u>S&P 500 % Return</u> | <u>SEM - Value of \$1,000,000</u> | <u>S&P 500 - Value of \$1,000,000</u> |
|---------------------------|---------------------------------|--|--|--|
| First Half 2011 | +5.43% | +5.99% | \$ 1,054,300 | \$ 1,059,900 |
| Three-Year | +4.58% | +3.28% | \$ 1,143,800 | \$ 1,101,700 |
| Five-Years | +3.59% | +2.89% | \$ 1,192,900 | \$ 1,153,100 |
| Ten- Years | +3.98% | +2.69% | \$ 1,477,100 | \$ 1,303,400 |
| Inception (13 ½ Years) | +6.37% | +4.09% | \$ 2,300,800 | \$ 1,718,800 |

* Composite results of all SEM managed accounts, net of all fees.

Note: Performance results for the three, five, seven, ten and since inception year periods represent the annual average rates of return.